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Agenda Item 6

October 17, 2011

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

I. SUBJECT: Revision of the Leverage Policy

II. PROGRAM: Asset Allocation/Risk Management

III. RECOMMENDATION: Recommend to the Investment Committee approval of the revised Leverage Policy

IV. ANALYSIS:

At its September 2011 meeting, the Investment Committee ("Committee") approved the use of equitization associated with the Absolute Return Strategies (ARS) Program for a one year period. This item requests approval of conforming language in the Leverage Policy (Policy.) The ARS Program has a zero policy allocation and an approximate 2.5% actual allocation funded primarily through an underweight to Global Equity (GE.) Equitization, long positions in equity futures contracts or their equivalents, will restore the actual equity exposure closer to its policy allocation at the total fund level.

The proposed language to be added to the Policy is the following: *"The notional value of noncash collateralized equitization shall not exceed the market value of the ARS program."*

This language establishes an upper limit on the notional exposure of equitization that is not fully collateralized with cash. Staff plans to scale the equitization so that the estimated equity exposure of the ARS Program and the noncash collateralized equitization combined does not exceed the market value of the ARS Program.

<u>List of Attachments</u>

- Attachment 1 - Wilshire Associates Opinion Letter
- Attachment 2 - Revised Leverage Policy and Glossary

V. RISK:

Equitization, as described in the September 2011 Investment Committee memo, results in investment risk more similar to that of the policy portfolio. Equitization also results in basis risk, a chance that the returns of equity futures will not match the returns of the underlying equity indices less cash. Potential tracking error from basis risk during volatile markets could be as high as a few percentage points of the equitization program or a few basis points of total fund returns.

VI. STRATEGIC PLAN:

This item addresses Strategic Plan Goals VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions; and IX, achieve long-term, sustainable, risk adjusted returns.

VII. RESULTS/COSTS:

The costs of revising the leverage policy are minimal. Transaction costs of equity futures are low relative to the costs of trading most other financial instruments. The result will be actual equity exposure closer to policy allocation.

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